

AUTOMATED TRADING SYSTEMS AND THE CONCEPT OF AN "EXCHANGE" IN AN INTERNATIONAL CONTEXT PROPRIETARY SYSTEMS: A REGULATORY HEADACHE!

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1. INTRODUCTION

In the age of rapidly evolving computer technology, the trading of securities and commodities, which traditionally has occurred on exchanges and commodity markets, is now also done on electronic systems. The degree of automation varies from system to system.¹ The speed and degree of automation is largely dependent on historical factors, such as the existence of a highly successful stock exchange and a highly organized securities industry. Automation is also dependent on the regulatory environment² and on cultural differences.³

Until now, equity markets have tended to be more automated than derivative markets. Within the equity market, there are three major types of trading systems: order driven (e.g., the CATS system); quote-driven (e.g., the NASDAQ system, also called a dealer market); and the specialist system of the NYSE which falls somewhere in between as an auction market. The first two types are largely automated. By contrast, the futures markets are essentially "open-outcry," although fully automated systems such as the Swiss Options and Financial Futures Exchange ("SOFFEX") exist.

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¹ For example, the "CATS" system of the Toronto stock exchange is a highly automated system which works without a physical trading floor. The "DOT" system of the New York Stock Exchange (the "NYSE"), an automated order routing system, is another example of an electronic exchange system.

² For example, U.S. stock exchanges, which are regulated by the Securities and Exchange Commission, a powerful watchdog, may be contrasted with the German Stock Exchange which operates primarily through self-regulating bodies.

³ For example, the prosecution of insider trading is typically an American regulatory concern.

To understand the automation process, one must consider the different functions normally involved in executing a trade. Typically, a trade includes: order collecting, order routing, execution, matching, reporting, clearing and settlement, and market information. One, more, or all of these functions can be automated into one integrated system, or a number of systems can be linked with each other.

Automation provides numerous possibilities for combinations and linkages. It does not restrict trading functions to the previously established exchanges and markets, which were often regarded as "public utilities." The only requirement for automated trading is a personal computer connected to another personal computer. While this set-up is not presently available to the ordinary customer, professionals, such as brokers and dealers, can create their own private systems referred to as "proprietary trading systems." With the advent and increased use of these proprietary systems, lawmakers are faced with the task of incorporating these technologies into existing securities regulatory schemes.

Because these systems are not limited by national borders, they can potentially have an enormous international impact. For the first time, automation has presented the possibility of creating a global marketplace that is not limited by geography or by time restraints.

The case, however, in favor of automated trading systems is undermined by a number of unresolved issues. One of the most important obstacles to an automated system is the existence of different regulatory regimes (both within a country and between different countries). The regulatory systems of various countries are not always compatible and harmonization is not easy.

Nations generally view the economic health of their country's financial markets as a matter of extreme significance. A breakdown of the financial system can have very serious consequences. Thus, economic and political considerations, such as investor protection and international competitiveness, have impeded the establishment of an international automated trading system.

Section 2 of this Article compares the regulatory regime of automated trading systems in different legal systems by examining the existing regulation of exchanges and markets in various countries. The problems associated with the

internationalization of such systems are discussed in section 3.

2. REGULATORY REGIME OF AUTOMATED TRADING SYSTEMS IN THE UNITED STATES, FRANCE, THE UNITED KINGDOM, AND THE EUROPEAN COMMUNITY

2.1. *The United States*

The power to regulate U.S. financial markets⁴ is shared by several agencies. The Securities and Exchange Commission (the "SEC") has jurisdiction over the corporate debt and equities markets⁵ and the Commodities Futures Trading Commission (the "CFTC") has jurisdiction over the futures market.⁶

The following section describes the regulatory regime of automated trading systems under the Securities and Exchange Act of 1934 (the "Exchange Act"), as administered by the SEC.⁷ The second section briefly discusses the Commodity Exchange Act ("CEA"), as administered by the CFTC.⁸

2.1.1. *Automated Trading Systems under the Exchange Act*

a. What is an Exchange?⁹

The Exchange Act treats exchanges as Self-Regulatory Organizations ("SROs") and submits them to a registration¹⁰

⁴ For a general discussion of taxonomy of financial markets such as the money market, the government securities market, the municipal securities market, the corporate debt market and the derivative product markets, see RICHARD JENNINGS ET AL., *SECURITIES REGULATION* 6-16 (7th ed. 1992).

⁵ The SEC also exercises certain regulatory functions over the government securities market and the municipal securities market.

⁶ With the development of new products it is not always clear whether the SEC or the CFTC has jurisdiction over a particular market. See, e.g., *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537 (7th Cir. 1989). The interdependence of the equities markets and the derivative markets was highlighted by the October 1987 market crash. See REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS 55-57 (Jan. 1988).

⁷ See 15 U.S.C. §§ 78a-kk (1988).

⁸ See 7 U.S.C. §§ 1-26 (1988).

⁹ See RICHARD JENNINGS ET AL., *supra* note 4, at 540-46; LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2657-66 (3d ed. 1990).

¹⁰ See 15 U.S.C. §§ 78f, 78s (1988).

obligation. Exchanges are defined in section 3(a)(1) as:

any organization, association, or group of persons whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or *facilities* for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market *facilities* maintained by such exchange. (emphasis added).¹¹

Section 3(a)(2) provides that a facility, when used in respect to an exchange,

includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticket or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.¹²

In addition, an over-the-counter ("OTC") market has been developed by broker-dealers, who must be members of a National Securities Association, a SRO,¹³ registered with the SEC according to section 15A of the Exchange Act.¹⁴

In order to register as a national securities exchange or as a national securities association, a number of requirements must be fulfilled. Those entities seeking registration must guarantee compliance by their members with the federal rules and the rules of the exchange. They must also provide that any registered broker or dealer may become a member, and fair representation of its members must be assured. The rules must prevent fraudulent and manipulative acts and practices, they cannot permit unfair discrimination between customers,

¹¹ *Id.* § 78c(a)(1).

¹² *Id.* § 78c(a)(2).

¹³ Currently, only the National Association of Securities Dealers (the "NASD") has been registered.

¹⁴ *Id.* § 78o-3.

issuers, brokers, or dealers, and they must provide fair disciplinary procedures. Additionally, the rules should provide for equitable allocation of fees, and changes of the rules must be filed with the SEC.

These requirements not only make it burdensome for an entity to be characterized as an exchange, but also act to considerably restrict the freedom of securities organizations and facilitate their exploitation. However, section 5 of the Exchange Act provides an exemption to this demanding registration process. Upon application to the SEC, if registration is not practicable or appropriate in the public interest, and is not necessary for the protection of investors, an exchange may be exempted from registration. These exemptions are often granted to trading entities that engage in a limited volume of transactions. For example, Wunsch Auction Systems, which operates a computerized single auction system for secondary market trading, has recently been exempted from registration requirements under section 5 of the Exchange Act.¹⁵

b. What is a Proprietary Trading System? The Instinet and POSIT Systems¹⁶

In 1969, the Institutional Networks Corporation ("Instinet")¹⁷ registered with the SEC as a broker-dealer.¹⁸ Yet, the services provided by Instinet exceed those of a

¹⁵ Self-Regulatory Org., Wunsch Auction Systems, Inc., Application for Limited Volume Exemption from Registration as an Exchange under Section 5 of the Exchange Act, Exchange Act Release No. 28,577 (Oct. 24, 1990), available in LEXIS, Fedsec Library, Secrel File; Self-Regulatory Org., Wunsch Auction Systems, Inc., Order Granting Limited Volume Exemption from Registration as an Exchange under Section 5 of the Exchange Act, Exchange Act Release No. 28,899 (Feb. 20, 1991), available in LEXIS, Fedsec Library, Secrel File; see also Dawn Gilbertson, *Electronic Trading is Ready to Make Debut in Phoenix*, WALL ST. J., Dec. 30, 1991, at B7.

¹⁶ See generally Brandon Becker et al., *The SEC'S Oversight of Proprietary Trading Systems* (paper presented at the Conference on Securities Markets Transaction Costs, Owen Graduate School of Management, Vanderbilt University, Apr. 11-12, 1991 (updated Oct. 10, 1991)).

¹⁷ Instinet is currently a subsidiary of Reuters Holdings PLC.

¹⁸ On September 8, 1986, Instinet obtained a no-action letter concerning the application of sections 3(a)(1), 5, 6 and 17A of the Exchange Act to its automated trading system. See Richard G. Ketchman, SEC No-Action Letter (Sept. 8, 1986), available in LEXIS, Fedsec Library, Noact File.

traditional broker-dealer. Instinet¹⁹ consists of a network of computer terminals which permits broker-dealers, as well as institutional investors, to insert messages signalling their interest in securities listed on registered exchanges and securities traded over-the-counter. The system also provides for the execution of trades and enables patrons to obtain trading reports. Clearing and settlement can also be secured through the Instinet system although actual clearing and settlement is not done by Instinet alone. Rather, pricing is determined by means of data obtained from four sources: (1) the Instinet system, (2) the Consolidated Transaction Reporting System ("CTA") and the Consolidated Quotation System ("CQS"), (3) the NASDAQ system, and (4) the TOPIC services of the London Stock Exchange. This system of pricing is otherwise referred to as "derivative pricing."

Instinet customers get their information in the form of a quote montage,²⁰ an Instinet book,²¹ trade and market data,²² a selective alert monitor²³ and a composite book.²⁴ Orders are entered anonymously and are compared with the existing interest in the Instinet book using a price and time algorithm. Customers can anonymously engage in communication with the customer of the selected entry from their terminal. Since 1989, orders for UK equities can be entered in the system. By informal agreement between Instinet and a London market-maker, orders, up to a certain limit, are

¹⁹ The description of the Instinet system is largely based upon the description in the comment letter of Instinet on rule 15c2-10 (Aug. 2, 1989).

²⁰ In response to customer inquiries about a given listed or OTC security, a list of the current markets on exchanges and in the OTC markets in that security is displayed.

²¹ The Instinet book contains an updated list showing orders and interest in the Instinet system in the same security.

²² Certain other information (not contained in the quote montage and in the Instinet book) regarding that security and the market as a whole.

²³ The monitor is a ticker-like display consolidating Instinet, CTA, CQS and NASDAQ order, trade and quotation data in securities of special interest to the particular terminal user.

²⁴ Customers may increase the number of stocks that they follow in some detail by designating them for display. The display page shows, in a one-line display per security, for up to 11 securities per page, the best bid and offer, with size, from the quote montage, and the best buy and sell orders from the Instinet book.

executed at the inside London market price as displayed on TOPIC (the information distribution system of the International Stock Exchange).

Another service offered by Instinet is its "crossing network." This service allows customers to insert trading orders for various stocks during the day. If there is a corresponding interest, these orders are executed at the closing price of the primary market. Recently, Instinet has offered a new service called the "market match crossing session."²⁵ This service enables customer orders to be matched prior to the opening of trading on registered exchanges and NASDAQ. These orders are then executed after the close of the day's trading at each stock's "volume weighted average price." This service allows passive traders, primarily institutional investors, to follow the market at a very low cost. After the match at 8:30 eastern time the orders become irrevocable, requiring these customers to bear any risk of an unanticipated market shift.

Instinet does not have retail customers, nor does it have discretionary accounts. It does not carry funds or securities (which are carried out by a clearing corporation). There are no specialists or market-makers; Instinet does not enter quotes, nor is there any obligation that it enter two-sided quotations.

Another broker-dealer, Jefferies & Company, Inc, created a system called Portfolio System for Institutional Trading ("POSIT").²⁶ POSIT was designed to permit institutional investors to trade entire portfolios. The computer system attempts to match the customers' orders. If necessary, Jefferies' staff members may intervene and suggest modifications to facilitate the transaction. Prices are determined on the basis of the security's primary market quotations.

Because these systems, and others such as Limitrader (an automated trading system in municipal and corporate debt), ostensibly fit the SEC's definition of an exchange they must be registered. However, an argument could be made that these systems were not contemplated by Congress in 1934 when it

²⁵ Alden S. Adkins, SEC No-Action Letter (Dec. 6, 1991), *available in* LEXIS, Fedsec Library, Noact File.

²⁶ Lloyd H. Feller, Esq., SEC No-Action Letter (July 28, 1987) *available in* LEXIS, Fedsec Library, Noact File (regarding the application of sections 5 and 6 of the Exchange Act).

defined the term exchange.²⁷ Moreover, the actual terms of the definition are themselves unclear.²⁸

c. Competition with Registered Exchanges

The requirements of registration, although burdensome, serve an important function. They protect the ordinary investor who cannot fend for himself or herself. However, for institutional investors, who are sophisticated in securities matters, the protection afforded by registration requirements is minimal. To the extent that they are exempted from registration requirements, automated systems are favored by institutional investors. The exemption offered to automated systems results in lower transaction costs, more liquidity, and increased trading opportunities.

The lack of regulation of proprietary systems has engendered much criticism.²⁹ However, despite complaints from the traditional exchanges alleging unfair competition, the SEC has adopted a no-action letter approach.³⁰ This approach has given proprietary systems a competitive edge over registered exchanges. Whereas any proposed rule change of a registered exchange must be published for public comment before receiving SEC approval, rule changes relating to proprietary systems may be made without giving the public the opportunity to review such proposals. However, on April 18, 1989, in an attempt to provide some regulation of proprietary systems, the SEC published proposed rule 15c2-10 providing for public comment on proposed rules of proprietary trading systems.³¹

²⁷ The legislative history is not very instructive in attempting to determine Congress's intent. See S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1933).

²⁸ "[F]acilities for *bringing together purchasers and sellers* of securities or for otherwise performing. . . the functions commonly performed by a stock exchange *as that term is generally understood. . .*" 15 U.S.C. § 78c(a)(1) (1988) (emphasis added).

²⁹ In 1969 the SEC proposed rule 15c2-10 which was not promulgated after the 1975 amendments to the Exchange Act. See 34 Fed. Reg. 12,952 (1969).

³⁰ Eleven no-action letters had been granted until the release of the new proposed rule 15c2-10. For a list, see *Proprietary Trading Systems*, Exchange Act Release No. 26708, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,402 (Apr. 11, 1989).

³¹ See *id.*

d. Proposed Rule 15c2-10

Under proposed rule 15c2-10 a sponsor³² would be required to submit an initial plan to the SEC for approval,³³ which would be published and reviewed to ensure that it complied with the rule.³⁴ The rule would apply to trading systems as defined in rule 15c2-10(b):

[T]he term "automated trading information system" shall mean any automated system for transmitting, among participants, subscribers, or customers, indications of interest to purchase or sell securities or offers to purchase or sell securities through the use of a computer or similar device, but does not include any such system sponsored, operated, and regulated by a registered national securities exchange or a registered national securities association.³⁵

The plan would have to contain, among other things, descriptions of the system, the sponsor, the access terms, the staffing, and the procedures in place to secure compliance by the participants with the plan and the Federal securities laws. The sponsor would also be required to keep, and provide, the SEC with the documents and records it needs to fulfill its functions. Moreover, should the sponsor have reasonable ground to suspect a participant of non-compliance, the sponsor is obligated to inform the SEC.

e. Responses to the Regulation of Proprietary Systems

Opponents of proprietary systems argue that the proposed regulatory scheme does not go far enough. They cite the absence of an obligation of fair representation,³⁶ and the lack

³² A sponsor is defined as "[A] person who organizes, operates, administers or otherwise controls, directly or indirectly, a trading system." See Rule 15c2-10(b)(1), 17 C.F.R. § 240.15c2-10(b)(1) (1992).

³³ The SEC may exempt, conditionally or unconditionally, any person from these provisions.

³⁴ These requirements were suggested in order to allay the SEC's concern that the mere imposition of regulatory conditions in a no-action approach to systems linked to foreign markets might be inadequate to ensure the viability and quality of intergovernment and intermarket surveillance.

³⁵ Rule 15c2-10(b)(1), 17 C.F.R. § 240.15c2-10(b)(1) (1992).

³⁶ Exchange Act § 6(b)(3), 15 U.S.C. § 78f(b)(3) (1988).

of disciplinary procedures (which are provided for in SRO regulatory schemes).

Conversely, proponents of proprietary trading systems argue that the obligations imposed on automated systems are excessive. They do not want to supervise their participants (as their customers are often competitors) except, of course, as to matters regarding their financial capacities, as these systems are "private" enterprises and pursue profits. Under the proposed rule, they must agree to ensure compliance by its participants with the plan and with federal securities laws. If they have reasonable grounds to suspect non-compliance, they are obligated to report it.

f. Caselaw Interpretation of an Exchange³⁷

In 1988, Delta filed an application with the SEC to register as a clearing agency.³⁸ Delta proposed to issue, clear, and settle options on U.S. Treasury securities, executed through an over-the-counter trading options system, operated by a broker-dealer, RMJ Securities Incorporated. For purposes of the transaction, Security Pacific National Trust Company would act as a clearing bank (i.e., facilities manager). Along with the temporary registration filed with the SEC,³⁹ the Division of Market Regulation issued a no-action letter⁴⁰ to RMJ Securities stating that it would not recommend enforcement action to the SEC if the system did not register as an exchange.

The Chicago Board of Trade ("CBOT") and the Chicago Mercantile Exchange ("CME") brought a judicial action contending that the system was required to register as an exchange. Judge Easterbrook dismissed the petition seeking review of the no-action letter, holding that such letter was non-reviewable. His ruling directed the SEC to conduct a preliminary inquiry to determine whether or not the proposed system was an exchange before it permitted Delta to register as a clearing agency. Only by reaching the answer to this

³⁷ Board of Trade of Chicago v. SEC, 883 F.2d 525 (7th Cir. 1989).

³⁸ The application was filed under section 17A of the Exchange Act. See 15 U.S.C. § 78a (1988).

³⁹ Exchange Act Release No. 26,450, 54 Fed. Reg. 2010 (1989).

⁴⁰ Delta Government Options Corporation, SEC No-Action Letter, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,335 (July 21, 1989).

question could the SEC determine whether or not Delta would be able to comply with the Exchange Act. In his opinion, Judge Easterbrook wrote:

The system is neither fish nor fowl, neither an exchange after the pattern of the Board of Trade and the New York Stock Exchange nor an over-the-counter market after the fashion of the NASDAQ. Developments in automation and communications are bound to produce more of these hard-to-classify entities. Section 3(a)(1) is a product of the '30s, the system a product of the '80s. We could not find a single case under Section 3(a)(1) discussing which attributes (if any) are necessary, and which are sufficient, for sorting a trading apparatus into the "exchange" bin.⁴¹

In accordance with the opinion, the SEC reviewed the RMJ system. On January 12, 1990,⁴² the SEC concluded that the RMJ system was not an exchange under the Exchange Act:

[W]hat distinguishes an exchange from brokers, dealers and other statutory defined entities is its fundamental characteristic of centralizing trading and providing purchasers and sellers, by its design (whether through trading rules, operational procedures or business incentives), *buy and sell quotations on a regular or continuous basis* so that those purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price quotations.⁴³

Dissatisfied with the SEC's ruling, the CBOT and CME again petitioned for review.⁴⁴ Judge Posner accepted the SEC's viewpoint that the RMJ-system was not an exchange within the statutory language. Citing *Chevron v. Natural Resources Defense Council*,⁴⁵ he wrote that "the statute is *not crystal clear* [and] [a]n administrative agency has discretion to

⁴¹ 833 F.2d at 535.

⁴² See Self-Reg. Org., Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 27,611 (Jan. 12, 1990) available in LEXIS, Fedsec Library, Secrel File.

⁴³ *Id.*

⁴⁴ Board of Trade of Chicago v. SEC, 923 F.2d 1270 (7th Cir. 1991).

⁴⁵ 467 U.S. 837 (1984).

interpret a statute that is not crystal clear."⁴⁶

In distinguishing between a statutory exchange and a proprietary trading system, the SEC's ruling appears to have placed great weight on the notion of liquidity. Because the proposed system did not provide for the continuous availability of two-sided quotes it was not considered an exchange. Although this appears to be an artificial distinction, until now, courts have not interfered with the SEC's decision and have relied on the SEC's interpretation.

g. May Foreign Automated Trading Systems Operate in the United States?

In 1988, the SEC announced its view of what it considered necessary for the creation of an international securities market:⁴⁷

[A]n effective regulatory structure for an international securities market system would include the following features:

(1) Efficient structures for quotation, price, and volume information dissemination, order routing, order execution, clearance, settlement, and payment, as well as strong capital adequacy standards;

(2) Sound disclosure systems, including accounting principles, auditing standards, auditor independence standards, registration and prospectus provisions, and listing standards that provide investor protection yet balance costs and benefits for market participants; and

(3) Fair and honest markets, achieved through regulation of abusive sales practices, prohibitions against fraudulent conduct, and high levels of enforcement cooperation.⁴⁸

Guided by these principles and using the U.S. Intermarket Trading System as its model for an international market

⁴⁶ 923 F.2d at 1273 (emphasis added) (citing *Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 844-45 (1984)).

⁴⁷ Regulation of International Securities Markets, Securities Act Release No. 6807, Exchange Act Release No. 26,284, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,431 (Nov. 14, 1988).

⁴⁸ *Id.* at 3.

system, the SEC contemplated that establishment of an international market system must begin with the creation of a worldwide securities market information system.⁴⁹ Once established, this security market information system would be followed by the development of international linkages between routing and execution systems, and clearance and settlement systems.

It was further contemplated that this system would be accompanied with adequate regulation of securities firms to secure the financial integrity of these entities and of the system as a whole.⁵⁰ Such regulation requirements included provisions for a sound disclosure system based on mutually agreeable accounting and auditing standards. Finally, it was expected that adequate rules would be promulgated to secure a fair and honest market and ensure cooperation among regulators.

h. The Current U.S. Regulatory Scheme

Unlike the law of other countries, such as the United Kingdom,⁵¹ U.S. federal law makes no accommodation for a market system operating in the United States and regulated

⁴⁹ It should be noted that concerns have been raised regarding the SEC's reliance on the ITS as its sole market model. Commentators have suggested that to avoid regulating difficulties that inevitably arise when dealing with various legal systems it might be more prudent to model an international market system upon the European "integration" experience. Instead of trying to harmonize all securities rules, the EC has adopted an approach which, through minimal harmonization and mutual recognition, assures the equivalence of the rules. Partly in response to such criticism, the SEC has recently taken some initiatives which will permit the American investor to participate more actively in international capital markets by permitting foreign issuers to use their legal system for some transactions, such as rights offerings, without subjecting them to U.S. securities rules. See Securities Act Release No. 6896, Exchange Act Release No. 29,274, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,802 (June 5, 1991).

⁵⁰ For a description of the registration requirements of foreign broker-dealers in the US, see David A. Lipton, *Registration of Foreign Broker-Dealers*, in *BROKER-DEALER REGULATION* 15 SEC. L. SERIES (comp. ed. 1988).

⁵¹ Under the Financial Services Act, the United Kingdom has recognized NASDAQ as a foreign market. See Order Approving Proposed Rule Change by the National Association of Securities Dealers, Exchange Act Release No. 29,812 (Oct. 11, 1991), available in LEXIS, Fedsec Library, Secrel File; see also Richard G. Ketchum, *NASD International Initiatives* (paper presented at the Securities Regulation Institute, University of California, San Diego, Jan. 22-24, 1992).

overseas.⁵² If an overseas system chooses to enter the U.S. market it must comply fully with existing registration and oversight requirements.⁵³

2.1.2. Automated Trading Systems under the Commodities Exchange Act

a. What is a Market

According to section 6(a) of the Commodities Exchange Act,⁵⁴ domestic futures transactions may only be executed on an exchange that has been designated as a contract market. Section 6(a) provides that:

(a) It shall be unlawful for *any* person to offer to enter into, to execute, to confirm the execution of, or to conduct any office or business anywhere in the United States, its territories or possessions, for the purpose of soliciting or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery (other than a contract which is made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions, *unless- (1) such transaction is conducted on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market" for such commodity; [and] (2) such contract is executed or consummated by or through a member of such contract market.*⁵⁵

An "exchange" can be designated as a contract market⁵⁶ by

⁵² For a discussion of market linkages, see Charles C. Cox & Douglas C. Michael, *The Market for Markets: Development of International Securities and Commodities Trading*, 36 CATH. U. L. REV. 833 (1987).

⁵³ Division of Market Regulation, U.S. Securities and Exchange Commission, *Automated Securities Trading: A Discussion of Selected Critical Issues* 8 (paper prepared for the IOSCO 1991 annual meeting panel on automated trading, Sept. 26, 1991).

⁵⁴ 7 U.S.C. § 6 (1988).

⁵⁵ *Id.* § 6(a) (emphasis added).

⁵⁶ A contract market relates to a particular futures contract which is issued by that market. An exchange can serve as designated contract

the CFTC if it fulfills the requirements of section 7 of the CEA. Among these requirements are a "public interest test" and the presence of rules regarding the dissemination of misleading information, the manipulation of prices and the admission procedures for members. Basically, these are the same requirements of an SRO, adopted to the particularities of futures contracts.

The requirement of a designated "contract market" excludes trading of futures contracts which occurs outside the exchanges. This creates a monopoly for the exchanges which does not exist in the securities markets, and effectively prohibits the viability of proprietary trading systems.⁵⁷

Although the CEA grants "exclusive" jurisdiction over futures contracts to the CFTC,⁵⁸ it is not clear if "hybrid" instruments, such as swap contracts, fall under the jurisdiction of the CFTC. Because the CFTC broadly interprets its jurisdictional scope much uncertainty has been created in this area.⁵⁹ "Hybrid" contracts, which are often customized to customers' needs, are generally traded on the over-the-counter market.⁶⁰ It is very likely that new screen-based trading systems will be developed in this context.

Under the authority of the CFTC, the markets, which are still open-outcry, are under strong pressure to automate. The creation of an audit trail, which prevents fraud, is an example of a necessary market system implement. If proven successful, the Globex system, which is intended to be an after-hour trading system, could also be operated during trading hours and could eventually replace the open-outcry system.

The CFTC has also received a Congressional mandate to establish and maintain research and information programs "to

market for more than one futures contract. In fact, the CBOT and CME are designated contract markets for more than 100 contracts.

⁵⁷ Jerry W. Markham, *The Commodity Exchange Monopoly-Reform is Needed*, 48 WASH. & LEE L. REV. 977 (1991).

⁵⁸ 7 U.S.C. § 2a (1988).

⁵⁹ The Senate re-authorization bill (S 207), passed in April 1991, contains a provision that would give the CFTC jurisdiction over a product if at least fifty percent of the product's characteristics makes it resemble a commodity. The version of the House bill (HR 707), passed in March 1991, does not contain such a provision.

⁶⁰ See *Wall Street Moves in on Futures Products*, WALL ST. J., Feb. 4, 1992, at C1.

determine the feasibility of trading by computer, and the expanded use of modern information system technology, electronic data processing, and modern communication systems by commodity exchanges, boards of trade, and by the CFTC itself for purposes of improving, strengthening, facilitating, or regulating futures trading operations."⁶¹

b. May Foreign Automated Trading Systems Operate in the United States?⁶²

Section 6(b) of the CEA provides:

The Commission may adopt rules and regulations proscribing fraud and requiring minimum financial standards, the disclosure of risk, the filing of reports, the keeping of books and records, the safeguarding of customers' funds, and registration with the Commission by any person located in the United States, its territories or possessions, who engages in the offer or sale of any contract of sale of a commodity for future delivery that is made or to be made on or subject to the rules of a board of trade, exchange, or market located outside the United States, its territories or possessions. Such rules and regulations may impose different requirements for such persons depending upon the particular foreign board of trade, exchange, or market involved. *No rule or regulation may be adopted by the Commission under this subsection that (1) requires Commission approval of any contract, rule, regulation, or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade, exchange, or market, or (2) governs in any way any rule or contract term or action of any foreign board of trade, exchange, or market, or clearinghouse for such board of trade,*

⁶¹ 7 U.S.C. § 22 (1988).

⁶² See PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, *COMMODITIES REGULATION*, §§ 3.38 B, 4.54 A (2d ed. 1982); Thomas A. Russo, *Regulation of the Commodities Futures and Options Markets*, in CFTC FOREIGN JURISDICTION (1983); Carl E. Stetz, *The New Regulation of Foreign Futures Contracts and Commodity Options: Is International Regulatory Uniformity Far in the Future?*, 14 BROOK. J. INT'L. L. 73 (1988).

*exchange, or market.*⁶³

On August 5, 1987, the CFTC issued a new regulation regarding foreign futures and foreign options transactions, effective February 1, 1988.⁶⁴ Under this new regulatory regime, foreign futures and options can only be offered or sold in the United States (1) by a person registered with the CFTC as (a) a Futures Commission Merchant ("FCM"), (b) an Introducing Broker, (c) a Commodity Pool Operator, or (d) a Commodity Trading Advisor; (2) by a foreign FCM who has an agreement with a domestic FCM for purposes of service of process and communications with the CFTC and the customer; or (3) by a person who obtained an exemption.⁶⁵ These provisions are not applicable, except for the anti-fraud and disclosure provisions, if a trading link between a domestic market and a foreign market permits positions in a commodity interest, established on one market, to be liquidated on another market.

Foreign options, but not foreign futures, need the approval of the CFTC before they may be offered or sold in the United States.⁶⁶ Futures and options contracts based on foreign government securities, as well as futures based on stock indices also require approval by the SEC.⁶⁷

Because section 6(b) of the CEA does not allow the CFTC to adopt rules or regulations regarding the approval of foreign contracts traded on a foreign exchange, foreign automated trading systems, such as SOFFEX, may operate in the United States, as there is no recognition procedure for markets. Under the current regime, SOFFEX would be able to install its terminals with a registered person in the United States. Other such examples of permissible automated trading include the Globex system.⁶⁸ Members of each participating exchange in Globex may trade any contract approved by its

⁶³ 7 U.S.C. § 6 (1988).

⁶⁴ 17 C.F.R. §§ 30.1-30.11 (1992).

⁶⁵ See, e.g., Mutual Recognition Memorandum of Understanding between the CFTC and the COB (June 6, 1990), 55 Fed. Reg. 23902 (June 13, 1990) (to be codified at 17 C.F.R. pt. 30) [hereinafter MRMOU].

⁶⁶ 7 U.S.C. § 6c (1988).

⁶⁷ See CEA § 2(a)(10), 7 U.S.C. § 2 (1988); Exchange Act § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1988).

⁶⁸ See *infra* notes 109-111 and accompanying text.

exchange⁶⁹ through the system from any location.⁷⁰

2.2. France

Oversight of French securities and derivative markets is quite complicated and is conferred upon several public and professional organizations. The main regulator is the Commission des Operations de Bourse (the "COB"), which was created in 1967.⁷¹ The COB's principal task is to protect and inform investors in public offerings,⁷² as well as in the secondary market, and assure the proper functioning of the securities and the derivative markets.⁷³ In addition to the COB, the Conseil des Bourses de Valeurs (the "CBV"), a professional organization, has established the General Regulations regarding the admission and revocation of broker-dealers, supervision of broker-dealers, functioning of the stock market, listing requirements, the admission and revocation of securities for negotiation, and the guarantee fund.⁷⁴ The Societe

⁶⁹ This is the so-called "side-by-side trading." It will also be possible, under certain conditions, for the members of one participating exchange to trade the contracts of the other participating exchanges. This is known as "cross-exchange trading."

⁷⁰ Of course, this is only true for locations within the jurisdiction of the supervising authorities of the participating exchanges.

⁷¹ Ordinance No. 67-833 of September 28, 1967, J.O. Sept. 29, 1967, 9589; 1967 D.S.L. 36.

⁷² Including shares in mutual funds.

⁷³ See Ordinance No. 67-833 of September 28, 1967, J.O. Sept. 29, 1967, 9589; 1967 D.S.L. 36, art. 1.

⁷⁴ Law No. 88-70 of January 22, 1988 states:

The council shall establish General Regulations to be ratified by the Minister of Finance after consultation with the COB and the French Central bank. The General Regulations define:

- all rules applying to the approval, withdrawal or suspension of brokerage firms, in conformance with article 4;
- all necessary rules for regulating the activities of brokerage firms;
- all rules relating to the operating conditions of the market and the suspension of quotations;
- all rules relating to the admission of securities for negotiations as well as cancellation of same;
- the conditions under which a professional card shall be granted to persons placed under the authority of or acting on behalf of, brokerage firms or the specialized financial institution, as well as to natural persons authorized by brokerage firms to act in their name;
- the conditions for creating and managing a guarantee fund

des Bourses Francaises (the "SBF"), the French "stock exchange,"⁷⁵ assures the implementation of the General Regulations of the CBV, and is the primary overseer of the brokerage firms.⁷⁶ Oversight of the futures market⁷⁷ has been conferred upon a professional organization, similar to the CBV, known as the Conseil du Marche a Terme (the "CMT"). The CMT is responsible for establishing the General Regulations,⁷⁸ applicable to all marketplaces, regarding the functioning of the market, the regulation and supervision of the intermediaries, and the admission and revocation of a contract.

2.2.1. Markets Supervised by the CBV

Presently, the SBF is the only recognized stock exchange. The SBF is comprised of a listed upper market (la cote officielle), a lower listed market (le second marche)⁷⁹, an unlisted market (hors cote), and an options market (Marche d'Options Negociables) ("MONEP").

a. What is an Exchange?

In France, the concept of a "securities exchange" is largely

designed to serve, in the interest of clients, as a guarantee of all obligations incumbent upon brokerage firms.

Law No. 88-70 of January 22, 1988, J.O. Jan. 23, 1988, 1111, art. 6.

⁷⁵ Article 10 of the 1988 law does not mention the phrase "stock exchange," but uses the term "specialized financial institution." *Id.* art. 10.

⁷⁶ However, it should be noted that the CBV may exercise disciplinary procedures.

⁷⁷ Law of March 28, 1885, J.O. Apr. 8, 1885, 1885 D.P.IV L. 25, on futures markets, modified by Law No. 85-695 of July 11, 1985, J.O. July 13, 1985, 7921, by Law No. 87-1158 of December 31, 1987, J.O. Jan. 5, 1988, 161 and by Law No. 89-531 of August 2, 1989, J.O. Aug. 4, 1989, 9822.

⁷⁸ Subject to approval by the minister of economy and finance, after seeking the opinion of the COB. Article 6 provides: "The General Regulations determine the rules to which operations on the market are submitted, notably the carrying out and recording of orders, as well as the means of supervision of those individuals and organisms active in the market. It determines the attributions of the organisms charged with running the market. The CMT approves specific regulations established by the special committees mentioned in article 5. These regulations set notably, technical rules specific to different contracts . . ." Law No. 87-1158 of December 31, 1987, J.O. Jan 5, 1988, 161 art. 6.

⁷⁹ The listing requirements are more lenient.

defined by the notion of a "public service."⁸⁰ Close regulation of the French exchange has effectively established a monopoly for the CBV as it is able to exert great influence over the market by requiring exchanges to comply with its General Regulations.⁸¹

Under articles 71 through 73 of the Commercial Code, an exchange is defined as a [physical] place, where businessmen come together, *under the authority of the government*, where the purpose of the trading is *the discovery of a price* determined by [regulated] intermediaries. The law of 1988, which was intended to modernize the regulatory structure of the financial intermediaries, provides additional insight into the securities exchange concept. Article 10 of the Commercial Code specifies that: "Transactions conducted by brokerage firms shall be recorded by a *specialized financial institution* [SBF] constituted among said firms."⁸² This requirement has had the effect of ensuring public disclosure of all transactions through the creation an internal control office designed to prevent and investigate violations of the securities laws and regulations. The internal control office may also perform clearing functions. Additionally, brokerage firms are required to submit their by-laws and their general manager nominees to the Minister of Finance for approval.

All trading of securities in France is done over an electronic system called the Cotation Automatisée en Continu. Clearing and settlement functions are also automated on the RELIT system.

b. Are Proprietary Trading Systems Possible?

Because the French regulatory regime operates in a quasi-monopoly fashion,⁸³ proprietary trading systems are very unlikely to exist for the following four reasons. First, broker-

⁸⁰ For a discussion of the government's role before the reforms, see ALBERT ROBUT, *LE DROIT DES BOURSES DE VALEURS ET DES AGENTS DE CHANGE* 335, Nos. 65-70 (1983).

⁸¹ It could be argued that this monopoly is justifiable for economic reasons.

⁸² Brokerage firms still enjoy a monopoly in negotiating securities. See Law No. 88-70 of January 22, 1988, J.O. Jan. 23, 1988, 1111, art. 1.

⁸³ The adoption of the investment services directive by the EC may change this.

age firms still enjoy a monopoly in securities trading;⁸⁴ therefore, institutional investors cannot participate in such systems. Second, under the Ordinance of 1945,⁸⁵ fines or prison terms of up to two years are imposed upon any person, including an intermediary, who brings together other persons for the purpose of trading or listing securities outside of an exchange. Third, proprietary systems could never meet the mandate of article 4-1-2 of the General Regulations of the CBV as securities, in most cases, will already be listed on a stock exchange. One could argue, however, that proprietary systems do not list securities. Fourth, the COB and the CBV can impede the establishment of proprietary systems by imposing additional conditions on the dissemination of price information.

2.2.2. *Markets Supervised by the CMT*⁸⁶

a. What is a Market?

The General Regulations⁸⁷ of the CMT define the futures and options market as the framework within which:

- Transactions are carried out in connection with standardized futures and options contracts, bearing directly or indirectly on financial instruments or commodities and listed by the CMT.

- Trading is organized on the basis of provisions approved by the CMT

- Clearing is performed by the clearing-house provided for in article 9 of the law of March 28, 1885.

Currently, the *Marché à Terme International de France* ("MATIF") is the only existing future and options market, but the establishment of additional markets is possible. The language appearing in article 6 contemplates the existence of "marketplaces."⁸⁸

⁸⁴ See Law No. 88-70 of January 22, 1988, J.O. Jan. 23, 1988, 1111, art. 1.

⁸⁵ Ordinance No. 45-2440 of October 18, 1945, art. 23.

⁸⁶ The COB also has jurisdiction in certain areas.

⁸⁷ General Regulations Concerning the Futures and Options Markets, J.O. Mar. 23, 1989, 3529, art. 1.

⁸⁸ "The CMT lays down the General Regulations of the market that are applicable to all marketplaces." See Law of March 28, 1885, J.O. Apr. 8,

2.2.3. May Foreign Automated Trading Systems⁸⁹ Operate in France?

In deciding whether a foreign automated trading system may operate in France it must first be determined if the trading system is a "market" or a "broker-dealer." If it is a foreign market, then it must be officially recognized by the Minister of Economy and Finance.⁹⁰ If it is a foreign broker-dealer dealing in foreign securities or other financial instruments, it is also subject to recognition requirement. If it is a foreign broker-dealer dealing in French securities or futures contracts in France, then it must comply with the French regulations on broker-dealers and financial intermediaries.

This preliminary characterization process is not always obvious. For example, if Instinet should install terminals in France, would it be considered a foreign or French broker-dealer? Or, should it be deemed a foreign or French market because its system contains French securities listed on the SEAQ-international? In the U.S. and in Great Britain, Instinet is regarded as a registered broker-dealer.

a. The Dual Requirements: Recognition and Reciprocity

Article 32 of the Law of August 2, 1989⁹¹ provides: "The public cannot be solicited, directly or indirectly, in any form whatsoever or by any means, to operate on a foreign market for securities, futures contracts or any other financial product, until the market has been *recognized* in line with conditions set by decree and subject to *reciprocity*."

Upon receipt of the COB opinion, recognition of a foreign market by the Minister of Economy and Finance will only

1885; 1885 D.P.IV L. 25, on futures markets, modified by Law No. 85-695 of July 11, 1985, J.O. July 13, 1985, 7921, by Law No. 87-1158 of December 31, 1987, J.O. Jan. 5, 1988, 161 and by Law No. 89-531 of August 2, 1989, J.O. Aug. 4, 1989, 9822.

⁸⁹ Foreign automated trading systems are not regulated by French law under the General Regulations of the CBV and CMT.

⁹⁰ Law No. 89-531 of August 2, 1989, J.O. Aug. 4, 1989, 9822, implemented by Decree No. 90-948 of October 25, 1990, J.O. Oct. 27, 1990, 13,026 (issued by the finance minister) and Regulation No. 90-10 incorporated in Order of September 20, 1991, J.O. Sept. 29, 1991, 12736 (issued by the COB).

⁹¹ *Id.*

occur when the rules relating to protection of investors, safety, supervision and monitoring of the market are considered to be equivalent to the French rules⁹² of the CBV and CMT. Furthermore, persons who are domiciled or have their registered office outside France are only authorized to contact the public in France regarding operations on a recognized foreign market upon approval by the competent supervisory authority in their country of origin. In addition, the competent French authorities must also have determined that the rules of competence, honorable character and solvency are equivalent to those applicable in France.⁹³ The reciprocity requirement ensures that persons authorized to operate in the markets placed under the authority of the CBV and CMT enjoy equal treatment in the country in question.⁹⁴ In addition to the requirements of reciprocity and recognition, before the execution of an order on a foreign recognized market, the intermediary must transmit a disclosure document to the client.⁹⁵

In an attempt to ease fulfillment of the recognition procedure of foreign futures and options markets, the COB and the CFTC signed a Memorandum of Understanding Regarding Mutual Recognition (the "MRMOU").⁹⁶ The purpose of the agreement, aimed at promoting an understanding among regulatory authorities was threefold.⁹⁷ First, it established recognition of the existence of an adequate regulatory regime.⁹⁸ Second, it addressed the recognition of persons and contracts.⁹⁹ Third, it addressed the notion of information

⁹² Decree No.90-948 of October 25, 1990, J.O. Oct. 27, 1990, 13,026, art. 1.

⁹³ *Id.* art. 3.

⁹⁴ *Id.* art. 1.

⁹⁵ Regulation 90-10, J.O. Sept. 29, 1991, 12,736, arts. 3-4. In cases where an order is executed on a derivative market, the disclosure document has to be sent by registered mail one week before the execution of the first order. *Id.*

⁹⁶ 55 Fed. Reg. 23902 (1990) (to be codified at 17 C.F.R. Pt. 30).

⁹⁷ See also Pamela Jimenez, *International Securities Enforcement Cooperation Act and Memoranda of Understanding*, 31 HARV. INT'L L.J. 295 (1990).

⁹⁸ See MRMOU, *supra* note 65, art. II.

⁹⁹ *Id.* art. V.

sharing.¹⁰⁰ The agreement provided for, *inter alia*, the offering and selling of French futures and options contracts¹⁰¹ by French intermediaries¹⁰² to clients residing in the United States¹⁰³ and vice versa.¹⁰⁴

In determining the equivalence of the rules relating to the market and the intermediaries, as far as a futures and options market is concerned, the following criteria are considered important:

- (a) [A]uthorization or registration of Persons who offer or sell Futures or Option Contracts, or accept orders and funds related thereto . . .
- (b) Financial requirements for Authorized or Registered Persons . . .
- (c) Systems for the protection of Client funds . . .
- (d) Record keeping and reporting requirements pertaining to financial and transaction information . . .
- (e) Requirements which govern sales practices . . .
- (f) Procedures to audit for compliance with, and to redress violations of, Client protection and sales practice requirements¹⁰⁵

In order for the intermediaries to be recognized, the mutual regulatory recognition has been supplemented by additional requirements regarding the protection of client funds, prudential requirements,¹⁰⁶ risk disclosure statements, and arbitration procedures¹⁰⁷ to smooth the differences among the regulatory regimes. This approach of mutual recognition and minimal harmonization is also followed by the EC in the

¹⁰⁰ *Id.* art. III.

¹⁰¹ Futures and options contracts traded on markets subject to the supervision of the COB.

¹⁰² Subject to the CMT jurisdiction.

¹⁰³ Without any additional registration, in accordance with the provisions of Part 30 of the CFTC's regulations.

¹⁰⁴ Without any additional authorization, in accordance with the provisions of article 32 of Law No. 89-531 of August 2, 1989, J.O. Aug. 4, 1989, 9822.

¹⁰⁵ See MRMOU, *supra* note 65, art. II.

¹⁰⁶ Problems of adequate capitalization of securities firms may soon be resolved by an international agreement, similar to the Basle agreement for banks.

¹⁰⁷ See 55 Fed. Reg. 23907 (1990) (side letter to MRMOU).

investment services directive and, due to its pragmatism, is probably the most effective approach.

Another essential element in this approach is the regulatory organizations' willingness to share information and to maintain high levels of cooperation among the regulatory organizations. Article III of the MRMOU provides that: "Each Authority acknowledges that its respective understandings set forth in this MRMOU are based on the existence of mechanisms to share information on an 'as needed' basis and to cooperate in inquiries, investigations, proceedings and compliance matters with respect to the laws and regulations subject to its jurisdiction."¹⁰⁸

It must be noted that, given the different nature of the various markets, the difficulties encountered in reaching such an agreement among regulatory authorities are significantly less in the derivative markets than in the securities market. In the futures market, the market itself is the issuer of contracts, while in the securities market, the companies are the issuers. In the latter case, the financial and economic structure of a country is more at stake and, therefore, it might be more difficult to obtain an agreement among regulatory agencies concerning recognition and reciprocity of foreign securities markets. The mutual recognition approach is also not appropriate in the context of the European Community. There, the adoption of the investment services directive¹⁰⁹ and the capital adequacy directive will create, under certain conditions, an open market for financial services.

b. The Globex System: A Case Study

Developed by Reuters, the CBOT, and the CME, Globex is an after-hours automated trading system¹¹⁰ in which MATIF is a participant.¹¹¹ The Globex system allows participants to trade futures and options contracts after their trading floor closes. Terminals are not only located in the United States and France, but also in London, Tokyo, and other cities,

¹⁰⁸ MRMOU, *supra* note 65, art. III.

¹⁰⁹ See Second Council Directive 89/646, 1989 O.J. (L 386) 1.

¹¹⁰ Jeffrey Taylor, *Globex Launch is Scheduled for June 25*, WALL ST. J., Apr. 8, 1992, at C1.

¹¹¹ Agreement of November 7, 1989.

creating a "global" trading system.

Although Globex is a "trading system," it neither lists contracts nor clears trades. Therefore, the CFTC need not recognize Globex as a market because its definition of a market is based on the listing of a contract and not on the manner of trading.¹¹² Even though the two requirements of recognition and reciprocity are fulfilled by Globex, many issues were extremely difficult to resolve, such as the question of which rules would be applicable to trading operations and participating intermediaries. For purposes of market recognition, it would seem to make more practical sense to recognize the participating markets as opposed to the Globex system as a whole. And, in fact, the CBOT and CME were among the markets which were recognized by the Minister of Economy and Finance.

2.3. *The United Kingdom*¹¹³

In 1986, the Financial Services Act (the "FSA") was adopted, overhauling the existing regulatory regime to institute a modernized, comprehensive regulation for financial services¹¹⁴ and to enhance investor protection. Strengthening the United Kingdom's international competitiveness was another major goal of the FSA.

At the top of the U.K. regulatory structure is the Secretary of State for Trade and Industry and the Department of Trade and Industry (the "DTI"). A large part of the Secretary's authority has been delegated to a private entity, the Securities and Investment Board (the "SIB"). The SIB may exercise its authority directly or through the recognition of professional organizations known as Self-Regulating Organizations.¹¹⁵ There are currently four recognized SROs: the Securities and Futures Authority (the "SFA"), the Financial Intermediaries,

¹¹² For requirements concerning foreign futures and foreign option transactions, see 17 C.F.R. Pt. 30 (1992).

¹¹³ See generally NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION 799 (1991); J.H. DALHUISEN, THE NEW UK SECURITIES REGULATION AND THE EC 1992 PROGRAM 158 (1989).

¹¹⁴ In the meantime, some European directives have been implemented.

¹¹⁵ Financial Services Act, 1986, ch. 60, § 8. There are also Recognized Professional Bodies ("RPBs"), such as the Law Society, whose main profession is not investment business.

Managers and Brokers Regulatory Association (the "FIMBRA"), the Investment Management Regulatory Organisation (the "IMRO"), and the Life Assurance and Unit Trust Regulatory Organisation (the "LAUTRO"). The operation of this regulatory scheme results in "practitioner based statute-backed regulation(s)."¹¹⁶

Because of its very complicated and sometimes overlapping structure, the U.K.'s regulatory system has been modified several times.¹¹⁷ For example, the prosecution of insider trading involves the SROs, the SIB and the DTI. There are now plans to set up a single self-regulatory organization for retail investors which would involve the merger of LAUTRO and FIMBRA as well as the integration of parts of IMRO and SFA.¹¹⁸ IMRO and SFA would continue to exist for wholesale investors.

2.3.1. *What is an Exchange?*

Under the FSA, all "investments" and "investment business" can only be carried out by an "authorized person"¹¹⁹ or "exempted person."¹²⁰ Schedule 1 of the FSA defines "investment business" as "dealing[s] in investments, arranging deals in investments, managing investments, investment advice, [and] establishing collective investment schemes."¹²¹ "Investments," are defined as "shares, debentures, futures and options."¹²²

It follows from section 3 of the FSA and the definitions in schedule 1 that an exchange or a market must be an authorized or exempted person under the FSA. Additionally, sections 36 through 39 of the FSA state that Recognized Investment Exchanges ("RIEs") and Recognized Clearing Houses ("RCHs") are exempt from the application of certain

¹¹⁶ Gower, *Review of Investor Protection* (Jan. 18, 1984) (on file with author).

¹¹⁷ For example, the merger between the Securities Association and the Association of Futures brokers and Dealers in the Securities and Futures Authority.

¹¹⁸ *See And Then There Were Three*, *ECONOMIST*, Mar. 21, 1992, at 84.

¹¹⁹ *See* Financial Services Act, 1986, ch. III.

¹²⁰ *Id.* ch. IV.

¹²¹ *Id.* sched. 1, §§ 12-16.

¹²² *Id.* sched. 1, §§ 1-11.

parts of the FSA. Section 40 of the FSA exempts Foreign Recognized Exchanges and Clearing Houses.

While the authority to recognize a domestic exchange has been delegated to the SIB, a foreign market must be recognized by the Secretary of State. The requirements for recognition are set forth in schedule 4. The exchange must have sufficient financial resources and must provide safeguards for investors. These safeguards require that dealings on the exchange be limited to those investments in which there is a proper market, adequate information and adequate performance of the transactions. The exchange must have adequate arrangements for monitoring, enforcement and investigation of complaints. It must be able to promote and maintain high standards of integrity and fair dealing, and cooperate, by sharing of information and otherwise, with the Secretary of State and the other relevant regulatory organizations.

There is no real definition of an exchange. Only a certain number of criteria have to be fulfilled to be recognized. These criteria are stated in rather general terms and permit a functional and flexible approach. Yet it is unclear if they are flexible enough to permit proprietary trading systems as they exist in the United States. If these systems are not "exchanges," then they must be authorized, or exempted under another scheme, most likely as a member of the SRO, comprising brokers and dealers. For example, the small order execution systems of the brokerage firms Kleinwort, Benson, and BZW are covered by the companies' membership in the SFA. The only obligations imposed upon them than are those applying to any other broker-dealer. Neither the DTI nor the SIB has the authority to require persons to seek recognition as an exchange if they would rather apply for authorization by a SRO or SIB.

The SIB, however, provides a special "service company" regime¹²³ to regulate the activities of companies whose sole investment business consists of arranging deals in investments by "making, or offering or agreeing to make arrangements with a view to a person who participates in the arrangements

¹²³ Securities and Investment Board, Conduct of Business Rules, rule 1.15 (on file with the *University of Pennsylvania Journal of International Business Law*).

buying, selling, subscribing for or underwriting investments."¹²⁴ The services considered are those involving more than the mere display of prices at which investors might wish to deal. Typically, these services encompass an intermediation or execution service. Such businesses are similar to the proprietary trading systems which exist in the United States.

In authorizing the service company, the SIB must consider if the applicant is "fit and proper" and meets the criteria of the service company regime. The services can only be provided to business investors and experienced investors.¹²⁵ The only Conduct of Business Rules applicable to service companies are those enumerated in rule 1.15. For example, the service company must provide an adequate complaint procedure.

Under the U.K. regime, six markets have been recognized: the Baltic Futures Exchange, the International Petroleum Exchange, the International Stock Exchange (the "ISE"), the International Commodity Exchange, the London International Financial Futures Exchange (the "LIFFE") and the London Metal Exchange.

The ISE based its new trading system, the Stock Exchange Automated Quotation ("SEAQ"), on the NASDAQ system. SEAQ is a quote driven system. Currently, the ISE is considering reforming its market through the creation of a wholesale market for institutional investors and a market for private investors.¹²⁶ The ISE also introduced a small order execution system, the Stock Exchange Automated Facility ("SEAF"). Clearance and settlement has not yet been automated and an attempt to develop an electronic system called TAURUS has failed.¹²⁷

¹²⁴ See Financial Services Act, 1986, ch. 60, sched. 1, § 13(b).

¹²⁵ For the definition of a business investor and an experienced investor, see Securities and Investment Board, Conduct of Business Rules, rules 1.04-1.06 (on file with the *University of Pennsylvania Journal of International Business Law*).

¹²⁶ See *A Tune-up for City Trades: The London Stock Exchange is Gearing up for Another Big Bang*, FIN. TIMES, Apr. 9, 1992, at 20.

¹²⁷ See Glenn Whitney, *Stock Exchange in London Drops Trading Project*, WALL ST. J., Mar. 12, 1993, A1.

2.3.2. *May Foreign Automated Trading Systems Operate in the United Kingdom?*

To determine whether the FSA is applicable to a particular investment business two criteria are employed: a person must carry on the investment business from a permanent place of business in the United Kingdom or engage (in the United Kingdom) in one or more of the activities that fall within schedule 1.¹²⁸ Exceptions, however, are made if the investment business is conducted through an authorized or exempted person,¹²⁹ if it is unsolicited, or in compliance with the cold calling and advertising restrictions¹³⁰ of sections 56 and 57 of the FSA. Whether a person is "engaging in investment activity," or the investment business occurs in a "permanent place of business" are questions of fact.

If the system falls under the FSA, it can, under certain conditions, obtain the status of a Foreign Recognized Investment Exchange or Clearing House.¹³¹ To obtain this status the system must be (1) subject to supervision in its home country where such supervision would provide protection to investors in the UK at least equivalent to that provided by the FSA in relation to investment exchanges; (2) be able and willing to cooperate, by sharing of information or otherwise, with the relevant authorities in the United Kingdom for purposes of supervision and regulation of financial services; and (3) provide adequate arrangements for cooperation between those responsible for the supervision of the system in the home country and the relevant authorities in the United Kingdom. Furthermore, when making this status determination, the Secretary of State may take into account the degree of reciprocity accorded to British persons in the home country of the system.

Cooperation between the regulatory authorities can take the form of a Memorandum of Understanding such as the one concluded between the DTI and the SIB on the one hand, and

¹²⁸ See Financial Services Act, 1986, ch. 60, § 1(3). The Secretary of State may by order amend the provisions of schedule 1 to extend or restrict the activities which constitute the carrying on of investment business in the United Kingdom. See *id.* § 2(1)(b).

¹²⁹ *Id.* sched. 1, pt. IV, § 26.

¹³⁰ *Id.* sched. 1, pt. IV, § 27.

¹³¹ *Id.* § 40.

the SEC and the CFTC on the other hand. However, the investment services directive will make these provisions inapplicable in the EC.

To date, three foreign markets have been recognized in the United Kingdom: the NASDAQ, the Chicago Mercantile Exchange (only with respect to contracts traded on GLOBEX), and the Sydney Futures Exchange. Instinet, on the other hand, has received broker-dealer status.¹³²

2.4. *The European Community*¹³³

As a part of its 1992 common market program, the European Community (the "EC") adopted a number of directives to create a common market in financial services. Three of the most important directives are the second banking directive¹³⁴ and two related directives regarding the capital basis of credit institutions.¹³⁵ Once the bank obtains a "single passport" in its home state, the bank may offer its services in all EC member states. Those services can be delivered regardless of whether the bank has a presence in the host state. It is assumed that prudential oversight will be exercised by the bank's home state.

The approach adopted by the EC is designed to achieve only the level of harmonization necessary to secure the mutual recognition of authorization and prudential supervision systems. This approach combines access deregulation with prudential re-regulation.

Because banking services in some countries include investment services involving securities, brokerage firms would be placed in an extremely disadvantaged position vis-a-vis the banking industry, which can freely operate within the EC. In an effort to equalize the position of banks and broker-

¹³² As an alternative to recognition, foreign markets may opt to obtain the status of a "designated exchange."

¹³³ See RICHARD M. BUXBAUM, *LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE: CORPORATE AND CAPITAL MARKET LAW, HARMONIZATION POLICY IN EUROPE AND THE US* 346 (1988); Manning G. Warren, III, *Global Harmonization of Securities laws: the Achievements of the European Communities*, 31 HARV. INT'L L. J. 185 (1990).

¹³⁴ See Second Council Directive 89/646, 1989 O.J. (L 386).

¹³⁵ See Council Directive 89/299, 1989 O.J. (L 124) (concerning the funds of credit institutions); Second Council Directive 89/646, 1989 O.J. (L 386) (concerning the solvency ratio for credit institutions).

age firms, the European Commission has proposed the Investment Services Directive (the "ISD")¹³⁶ and the related capital adequacy directive.¹³⁷

Under the proposed directives, once the investment firm obtains a single passport in its home state, the passport will permit investment services to be offered in all the EC member states, directly or indirectly, by establishing a branch. Investment services will include brokerage, dealing as principal, market making, portfolio management, underwriting, investment advice, safekeeping, and administration.¹³⁸ These services are applicable to transferable securities, including units in undertakings for collective investment in transferable securities, money market instruments, financial futures and options, exchange rate and interest rate instruments.¹³⁹

Because investment services are closely related to investment exchanges, the directive contains a clause liberating access to these exchange. The clause essentially provides that access can no longer be based on nationality.¹⁴⁰ For example, an English broker would be able to become a member of the Paris Stock Exchange. Under the proposed directive, membership would be based on compliance with the rules governing the structure and organization of the relevant market. The ISD also requires the states to draw up prudential rules¹⁴¹ for investment firms, which are to be adminis-

¹³⁶ Proposal for a Council Directive on Investment Services in the Securities Field, 1990 O.J. (C 42) 7 [hereinafter ISD].

¹³⁷ Proposal for a Council Directive on Capital Adequacy of Investment Firms and Credit Institutions, 1990 O.J. (C 152) 6. Although not yet adopted by the European Council, the aim of the directive is to protect the investor, the institution's business partners, and the whole financial system.

¹³⁸ See Annex to the ISD, sec. A.

¹³⁹ *Id.* sec. B.

¹⁴⁰ *Id.* arts. 12-16. Section B provides that "host Member States shall ensure that investment firms which are authorized to provide broking, dealing or market-making services by the competent authorities of their home Member State can have access, either directly or indirectly, to membership of *stock exchanges and organized securities markets* of host Member States where similar services are provided and also to membership of clearing and settlement systems there which are available to members of such exchanges and markets." *Id.* art. 13 (emphasis added). There is a similar provision for financial futures and option markets.

¹⁴¹ *Id.* art. 11.

tered by the home state.

2.4.1. *What is an Exchange?*

One of the unresolved issues, however, is the scope of the directive. It is unclear whether the directive will be applicable only to transactions executed on a “regulated market,” as proposed by France and some other southern countries, or whether it will be applicable to all investment transactions on or off the market, as proposed by the United Kingdom and Germany. Related to that question is the degree of transparency imposed on the markets and the direct access of banks. It should be noted that in the case of a directive that is restricted to “regulated markets,” proprietary trading systems, to the extent they are permitted in the member states, are not covered.

For purposes of the directive, regulated markets are characterized by: regular functioning, trading rules regarding the functioning and accessibility of the markets approved by a competent authority, listing requirements, and fulfillment of the transparency rules as defined by the directive. In the case of a market operating without any requirement for a physical presence, investment firms¹⁴² can become members without establishing themselves in the host state.¹⁴³ The ISD also provides for supervision of investment firms and cooperation among member states for the exchange of information.¹⁴⁴

The diversity of national practices once again raises the issue of what constitutes a market. Contrasts between France and Great Britain illustrate this problem. Great Britain has a quote-driven market, SEAQ-international, which requires reporting only within ninety minutes after the execution of the

¹⁴² As defined in the ISD.

¹⁴³ ISD, *supra* note 136, art. 13(3).

¹⁴⁴ *Id.* art. 18(3). Article 18(3) provides: “Where investment services are provided on a services basis across frontiers or by the establishment of branches in one or more Member States other than the home Member State[,] the competent authorities of the Member States concerned shall collaborate closely in order to supervise the activities of the investment firms concerned. They shall supply one another on request with all information concerning the management and ownership of such investment firms that is likely to facilitate their supervision and the examination of the conditions for their authorization and all information likely to facilitate the monitoring of such firms.” *Id.*

trades. The French stock market is an order-driven market which contains more stringent transparency rules.¹⁴⁵ The French require real-time (i.e., immediate) reporting of transactions. Moreover, the exposure of the dealers in a quote-driven system is less than in an order-driven system and the time delay permits the dealers to undo their positions.

Experience and research suggest that an order-driven system is more often adopted for the small investor and a quote-driven system more often adopted for the large investor.¹⁴⁶ These differences in a market system reflect a different view of the market concept and the role of the state: on the one hand is the U.K. system where a free market competes with other markets, policed by minimal requirements and prudential oversight necessary to guarantee the integrity of the financial system and, on the other hand is the French system which is essentially monopolistic.

If the scope of the directive is restricted to "regulated markets" it would severely limit the availability of a variety of services that are accessible in a technological system. An automated system permits almost unlimited access to markets and real time information. On the other hand, the benefits of automated systems must be balanced against the states' interests in protecting investors, which insist upon the adoption of a cautious approach with respect to such systems. Presently, no agreement has been reached concerning the scope of access deregulation and the extent of prudential re-regulation.

2.4.2. *Regulatory Oversight and Market Evolution*

When considering the method of oversight of an automated market, the "nationality" of the system, or its localization, must be established in order to determine the most competent regulator. Three possibilities have been proposed: (1) the state of incorporation of the entity organizing the trading, (2) where the incorporation is outside the EC, the state where the

¹⁴⁵ Under certain conditions, block trading off-exchange is permitted. See General Regulations of the CBV, art. 6-3-1.

¹⁴⁶ *Last Orders?*, THE ECONOMIST, Mar. 14, 1992, at 91; Marco Pagano & Ailsa Röell, *Trading Systems in European Stock Exchanges*, 10 ECON. POL'Y 65 (1990).

trade matching system is installed, and (3) if no such system is installed in a member state, the state of the system's first commercial presence.¹⁴⁷ In the latter case, if the system is commercially present in more than one member state, the member states may choose which state should serve as regulator.

The implementation of the ISD, as well as the implementation of other rules and directives, such as the insider trading directive addressing securities law, will necessitate close cooperation among regulators. Should the level of integration rise to a high enough level, it might be necessary to establish a regulatory organization on a European level. Because it is conceivable that the SROs could play an important role in the future, an organization at a European level might be warranted.¹⁴⁸

Integration of the securities market, whether accomplished through an inter-market trading link or the creation of a European stock market and a European derivatives market, is slowly beginning to occur.¹⁴⁹ Because of the free circulation of capital in the EC, the technological and regulatory changes have become increasingly necessary. Competition is strong and capital tends to flow to those markets that are most efficient, liquid and cost-effective. The potential risks for international recognition of automated systems are enormous, but the potential rewards are too large to be ignored. Recognition of automated systems promises to deliver new perspectives for harmonization, or mutual recognition of varying securities laws at an international level. In fact, the EC and the SEC have already signed a joint statement concerning the exchange of information¹⁵⁰ about the administration and enforcement of U.S. and EC member states' securities laws.

¹⁴⁷ This does not mean that non-EC systems can automatically operate within the EC.

¹⁴⁸ Such organizations, such as the European Association of Securities Dealers ("EASD"), have been formed for securities markets.

¹⁴⁹ Two such initiatives warrant special mention: "Euroquote" and "Eurolist." Euroquote, which has been rejected, would have provided an European-wide system for the dissemination of price and company news. Eurolist would provide for a single European listing for leading European companies at all or some of the European stock markets.

¹⁵⁰ This agreement was signed on September 23, 1991. See 23 Sec. Reg. & L. Rep. (BNA) 1406 (1991).

3. PROBLEMS RELATED TO INTERNATIONALIZATION AND REGULATORY CONCERNS

The policy goals for an international market are substantially the same as those of a purely domestic market; namely, efficiency, systemic stability and investor/client protection. Maintenance of international competition is yet another concern in the development of an international marketplace.¹⁵¹ It is commonly believed that a pragmatic approach is best suited to achieve these goals. Essentially, "[w]hat is needed is a process of continuing review of regulatory policies which is sensitized to changes in trading and the operation of markets."¹⁵² The most likely obstacles to arise in the internationalization process concern the regulation of a) the system, b) the system users, c) securities laws-market practices, and d) securities instruments and other financial products.¹⁵³

3.1. The System

The first distinction to be made is the difference between the system sponsor and the system provider. In the most basic scheme, the system sponsor is the organizer of the market and the system provider is the developer and/or operator of the system. However, it is possible to have more than one sponsor located in different jurisdictions. Also, more than one system provider may be located in more than one jurisdiction. Frequently, operations are contracted out to others.

¹⁵¹ See OECD, *Automation of Securities Markets and Regulatory Implications*, in 50 FINANCIAL MARKET TRENDS, Oct. 1991, at 20, 32; OECD, *Recent Trends in the Organization and Regulation of Securities Markets*, in FINANCIAL MARKET TRENDS, May 1990, at 17, 19; OECD, *Arrangements for the Regulation and Supervision of Securities Markets in OECD Countries*, in FINANCIAL MARKET TRENDS, Nov. 1988, at 17, 19-20.

¹⁵² Robert P. Austin, *Regulatory Principles and the Internationalization of Securities Markets*, 50 L. & CONTEMP. PROBS. 228 (1987).

¹⁵³ See also Regulatory Issues in International Automated Securities Trading Systems, International Law Association, Committee on International Securities Regulation, draft (Nov. 13, 1991); OFFICE OF TECHNOLOGY ASSESSMENT, TRADING AROUND THE CLOCK: GLOBAL SECURITIES MARKETS AND INFORMATION TECHNOLOGY (1991); OFFICE OF TECHNOLOGY AND ASSESSMENT, ELECTRONIC BULLS AND BEARS: US SECURITIES MARKETS AND INFORMATION TECHNOLOGY (1990); Friedrich Kubler, *Regulatory Problems in Internationalizing Trading Markets*, 9 U. PA. J. INT'L BUS. L. 107, 111-120 (1987).

3.2. *The System Sponsor*

The system sponsor(s) may be an existing market(s), or a newly created market (e.g., Instinet). In the case of a newly created market which is active in different jurisdictions, or in the case of several existing markets which are located in different jurisdictions, it is unclear which factors will determine the "nationality" of the system. Yet, the determination of "nationality" is important when considering the regulatory interest of the different countries.

Typically, when dealing with a domestic system with trading terminals installed abroad, where the securities or contracts listed and traded are not from the host country, responsibility for regulation lies with the appropriate authority in the home country. Likewise, where securities or contracts listed and traded are from the host country, primary responsibility remains with the home country, although cooperation and information sharing with the competent regulator of the host country is necessary.

In the case of a system whose "nationality" cannot be easily determined, regulatory oversight may be shared by agreement or, the system sponsor may be allowed to elect a regulatory regime. However, adoption of this system of election will likely yield a tendency to adopt the least regulated regime.

An agreement between regulators, whether implicit or explicit, to share responsibility for regulation may be based upon the original place of listing or the location where the security or contract was admitted.¹⁵⁴ However, it should be noted, that this system of determining a national regulator would not be possible in the case of securities or contracts traded solely on the system.

An example of the chosen option of the regulatory regime is illustrated by the regulation of the Transaction Exchange ("TRAX"), a trade comparison and trade reporting system of the Association of International Bond Dealers (the "AIBD").¹⁵⁵ Other more traditional methods of regulatory oversight include a regime whereby responsibility for regulation is shared by the government or its designated agency, and

¹⁵⁴ For example, Globex.

¹⁵⁵ TRAX is subject to the requirements of the FSA.

the system.¹⁵⁶ In this regulatory scheme, the system acts as a SRO. However, although this mode of regulation is appropriate in a domestic market, it may be ineffective in an international context. It is highly probable that a proprietary system often will not want to exercise the responsibilities of an SRO because the costs may be prohibitive.¹⁵⁷ Additionally, because of the existence of blocking statutes, SROs cannot freely transmit information abroad or cooperate with foreign authorities. These operational restrictions would greatly impede the successful functioning of proprietary systems.

The determination of the most competent regulator is crucial to ensuring the financial integrity and efficient functioning of a proprietary system. However, in addition to selecting an appropriate overseer, it must also be determined which country's trading rules will be applicable. For example, can France permit a U.S. proprietary system to operate in France according to trading rules in conflict with its own mandatory rules? Alternatively, can the Deutsche Terminborse (the "DTB"), the German Financial Futures and Options Exchange, operate in France simply by installing terminals? It is obvious that an agreement between regulators is critical to the regulation process.

Perhaps, it might be possible to permit different trading rules in one system. If so, then the question arises: which criteria would trigger the application of different rules; (1) the type of system user (i.e., wholesale market, professional's market,¹⁵⁸ or retail market), (2) legal requirements of the jurisdiction in which the system operates,¹⁵⁹ (3) the place of execution of the trade (i.e., the place where the main computer which executes the trade is installed, the place where the offer is accepted, or the place where the offer is entered), (4) the type of contracts or securities listed, (5) the place where the contracts or securities are listed,¹⁶⁰ or (6) a combination of

¹⁵⁶ For example, NASDAQ.

¹⁵⁷ Another reason is that proprietary trading systems, at least in the United States, are often operated by a broker-dealer. Consequently, many of their customers are also broker-dealers, and thus competitors.

¹⁵⁸ For example, a broker's brokers market.

¹⁵⁹ For example, a monopoly for brokers.

¹⁶⁰ Adoption of this criteria would permit each jurisdiction to apply its rules regarding its own contracts or securities. This is particularly true for

the preceding criteria.

3.3. *The System Provider*

In most cases if the system regulator is subject to regulation it will be unnecessary to subject the system provider to the control of a separate regulatory authority. However, it may be necessary to develop procedures for dealing directly with the system provider when matters, such as assessing computer capacity, need to be addressed.¹⁶¹

3.4. *The System Users*

Just as important as the regulation of the system is the presence of adequate regulation and oversight of the system users. Principle 6 of the IOSCO suggested principles provides: "procedures should be established to ensure the competence, integrity, and authority of system users and to ensure that system users are adequately supervised, and that access to the system is not arbitrarily or discriminatorily denied."¹⁶²

Basically, two main categories of users can be distinguished: regulated persons, such as brokers-dealers, and non-regulated persons, such as individual investors.¹⁶³ The latter category may be further divided into institutional investors and other investors, because institutional investors, such as insurance companies, are often regulated under other schemes and it is generally believed that they can adequately protect themselves.

In the strictest regulation scenario, access to the system is determined by the laws and regulations of the system's home country and the laws and regulations of the host country (the country where the system user resides).

the futures markets, which are the issuers of their listed contracts. This solution has been adopted by Globex. Although, it is still considered desirable to have as many harmonized rules as possible, it is far less feasible for securities trading markets to adopt this solution because there are usually multiple listings.

¹⁶¹ See Institutional Organization of Securities Commissions, Working Party 7 [IOSCO], Comment Principle No. 10, Suggested Principles for the Oversight of Screen Based Trading Systems for Derivative Products (May 21, 1990).

¹⁶² See *id.*

¹⁶³ Not regulated by the securities laws.

For example, section 7.3 of Instinet International subscriber's agreement provides that:

[a] subscriber will monitor its authorized personnel to ensure. . . for purposes of access to the Instinet system, that all authorized personnel abide by and comply with all applicable provisions of the securities laws, rules and regulations of the United States and subdivisions thereof, of the jurisdiction or jurisdictions in which subscriber resides, and of any self-regulatory securities organization or securities exchange of which subscriber. . . is [a] member.¹⁶⁴

Under this scheme, the regulation of the organization and activities of its users is usually governed by the laws and regulations of the user's home country.¹⁶⁵

Prudential oversight can best be exercised by the user's home country, although a minimal harmonization of differing national rules is still required. This system of regulation effectively achieves prudential oversight and requires minimal harmonization of differing national rules.¹⁶⁶ All that is needed is a cooperative (bilateral or multilateral) arrangement, with the regulators of the countries in which the system is active (especially with the primary regulator of the system) allowing the implementation of a proprietary system. This is the regulatory approach that has been adopted by the EC.¹⁶⁷

An alternative to this approach is to appoint a regulator in the location where the system maintains its corporate presence or in the home country of the system sponsor. This solution is particularly well-suited to domestic systems that are planning to expand abroad. The primary advantage of this approach is centralization of the oversight of the system and the system users under one regulator. This solution inevitably restricts access to those located abroad as it requires a presence in the home country. However, even under this system, the regulator

¹⁶⁴ Instinet, Instinet International Subscribers Agreement, § 7.3 (n.d.).

¹⁶⁵ Of course, the user may be subject to the regulations of other countries depending on its "contacts" with that country. For instance, if a French broker sells securities to American investors, he will also become subject to the American securities laws and regulations.

¹⁶⁶ For example, the prudential principles adopted by the IOSCO.

¹⁶⁷ See *supra* section 2.4.

of the host country maintains an interest in supervising the system users, to the extent that the financial integrity, and other economic interests of the host country, are implicated. This is especially true given the interdependence of financial markets.

3.5. Securities Laws and Market Practices

Compliance with conflicting securities laws and regulations and the existence of blocking statutes present a tremendous impediment to the establishment of proprietary systems that has yet been resolved. Probably the most obvious example of this conflict is illustrated by the insider trading laws.¹⁶⁸

3.6. Security Instruments and Other Financial Products

In general, to be listed on a stock exchange or traded on a derivatives market, a certain number of conditions or requirements must be fulfilled. These listing requirements ensure a minimum safety level for the investor and the integrity of the financial system.

In order to avoid a loosening of these standards by using a cross-border trading system, the requirement of a listing process might be imposed or, at the very least, certain minimum requirements which would take into account the type of system user, should be imposed.

4. CONCLUSION

Many new technological and regulatory problems, such as equal access to the system, prudential oversight, and enforcement of rules and regulations, have been created by screen-based trading systems. At the same time, however, the advantages of implementing automated systems are numerous. Under an automated system, the market is no longer bound to a specific physical location and can become truly international. Among other things, automated systems will lead to increased market transparency (i.e., possibility to obtain real time information), and the creation of less uniform markets (or fragmented markets) that are suited to the needs of particular

¹⁶⁸ Other such examples include take-over laws and reporting requirements.

customers (e.g., a wholesale market and a retail market). Although fragmented markets may result in liquidity problems, access limitations, and an increased need for regulatory oversight of the market and its intermediaries, the benefits inherent in creating a truly international system far outweigh the potential difficulties that might be encountered during implementation.

With the advent of automated systems, the concept of an exchange has evolved into a global concept, while the regulation and enforcement of securities laws are still exercised at a national level. To ensure the viability of an automated system, extensive cooperative efforts among regulatory agencies is necessary.¹⁶⁹ At the European level, there is an additional effort to harmonize the different legal systems.¹⁷⁰ However, greater efforts must be undertaken because otherwise securities markets will escape effective regulatory control and the protection of the investor, one of the basic aims of special regulation, will be jeopardized. The predominance of institutional investors in the securities markets and the blurring of distinctions between the securities markets and other financial markets add another dimension to the regulatory structure. Not only is the protection of the investor at stake, but the integrity of the entire financial system as well.

The favorable attitude of the SEC toward new trading systems, the existence of both exchanges and an OTC-market, and the size of the securities markets encourage intermediaries to be innovative and to offer new types of exchange services. To acknowledge the possibility of new market systems, the previous distinction between "on exchange" and "off exchange" transactions should be replaced with terminology that recognizes a distinction between wholesale and retail markets.

However, despite the apparent receptivity to creative exchange services, the existence of a highly regulated securities market has made it burdensome for foreigners to raise capital in the U.S. market or to offer foreign investment services. The present situation poses a difficult challenge to

¹⁶⁹ One of the means to achieve cooperation is the use of Memoranda of Understanding.

¹⁷⁰ The IOSCO also plays an important role in bringing together the different regulators.

the SEC and the CFTC to modernize the regulatory structure and internationalize their markets, without trying to Americanize the international markets.

To date, France and the United Kingdom have undertaken great efforts to internationalize their markets. The Investment Services Directive will further liberalize access and strengthen prudential oversight, not only in France and the United Kingdom, but throughout the EC. The scope of the ISD is still unclear because the concept of an exchange has not been decisively determined.

What is an "exchange?" Is it a price discovery mechanism that needs regulation because it is an essential element in our free market system? Adapting the definition of an exchange to conform with the technological advancement and internationalization of the markets has proven to be a hefty task. Although solutions are not easily found, they are not impossible. In sifting through the regulatory conundrum, the approach taken by the EC is a helpful guideline.